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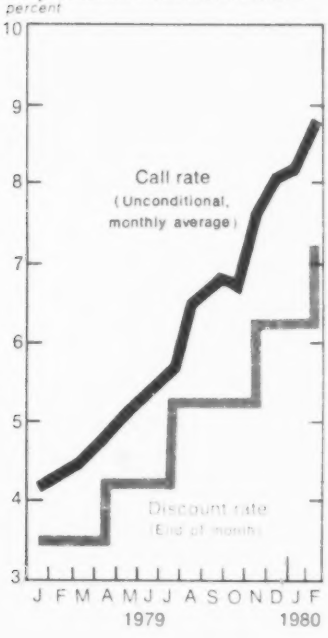
Japanese Monetary Policy Tied to Yen Defense?

The timing of the recent hike in the Japanese discount rate underscores the increasing impact of exchange-market events on Japanese monetary policy. With the yen showing a renewed tendency to weaken, the authorities were unwilling to risk the possibility of another major attack on the yen arising from an abrupt widening in U.S.-Japanese interest rate differentials. Nonetheless, the Japanese decision has all the earmarks of a compromise. The Bank of Japan reportedly argued for a larger rate jump than that taken. The Ministry of International Trade and Industry, concerned for corporate profits and investment, apparently urged delay in rate adjustment. The Ministry of Finance seems to have been torn two ways, its concern for the impact of a weaker yen on domestic inflation pitted against its worry about the implication of higher debt-service costs. But having settled on the step taken, it will be difficult to make a further adjustment in the near future, for such an action would greatly complicate current parliamentary discussions on the FY 1980 budget.

Japanese interest rates



Even so, it is anybody's guess as to how long the new discount rate will survive. Domestic inflation is accelerating rapidly, and the year-over-year increase in the Japanese consumer price index will approach 8% as the spring wage negotiations enter their crucial stage. The most recent trade data indicate that the long-expected turnaround in the balance of payments is still some time away, even though the growth of Japanese export volume has generally matched expectations. And despite the matching increase in U.S. and Japanese discount rates, the *difference* between short-term interest rates in U.S. and Japanese markets is now 50 basis points greater than a few weeks ago.

Under these circumstances, continued pressure on the yen seems likely in the short run. If so, the Japanese authorities can be expected to mount a vigorous defense of the yen, activating the swap lines with the United States and withdrawing dollar deposits from Japanese banks overseas if necessary to acquire the currencies needed for large-scale market intervention. It seems questionable, however, that a yen-defense package would not include further increases in domestic interest rates if U.S. rates climb significantly from current levels. Whatever, the events of the next month or so should provide a good test of just how close the linkage between the foreign-exchange market and Japanese monetary policy has become.

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German real wage gains moderate.

The benchmark for Germany's 1980 wage round is the recent agreement with the metalworkers' union. Base wages are to rise 6.8%, and, in view of adjustments for the lower-paid, overall hourly wages will increase by about 7%. This is well below what many observers had expected, particularly because of last year's 5.4% rise in consumer prices, which exceeded the rise in hourly wage rates (but not that of actual earnings). The official year-on-year inflation forecast of 4.5%-5% for 1980 appears rather optimistic in light of anticipated movements in unit labor costs and import prices. Inflation is more likely to finish the year at 5.5%-6%, reducing real hourly wage gains to the 1%-1.5% range. With real GNP expected to grow between 1.5%-2%, or slightly below official forecasts, money supply growth in 1980 will likely fall in the upper end of the Bundesbank's 5%-8% target range, given unchanged velocity.

Italian economy set to slow from fast pace in 1979.

Italy's economy is now feeling the effects of over-expansionary economic policy and high oil prices. While real growth in 1979 is estimated at 4.5%—among the highest in Western Europe—the year-on-year inflation rate reached 22% in January, as against 13% in January 1979. The trade deficit widened sharply in the last months of 1979, giving Italy an estimated $5.7-billion deficit for the year, compared with the $425-million shortfall of 1978. The country's current-account surplus, a result of its traditional invisibles surplus, narrowed from $6.3 billion in 1978 to between $1-$1.5 billion in 1979. With world trade set to slow sharply and the average price of oil imports expected to rise at least as much in 1980 as in 1979, the current account is likely to shift into deficit this year. Such deterioration, combined with Italy's high inflation and rising world interest rates, could mean higher interest rates in the near future and an approximate halving of Italy's real growth rate in 1980.

Swedish economy retrenching.

In the face of an anticipated slowdown of most Western economies in 1980, the Swedish Government has begun to reign in its own economy. The authorities are motivated by the desire to avoid a repeat of the situation following the 1974 oil price run-up when strong Swedish growth matched by a worldwide recession led to a massive balance-of-payments deficit and high inflation. Public spending plans have been scaled back, and subsidies to weak industries—such as shipbuilding—are being reduced sharply. The Government had previously been expecting some 3% growth this year after 4.25% in 1979; an overall balance-of-payments deficit of 12 billion kronor, versus kr. 8.6 billion in 1979; and a rate of inflation of about 7%. But it now appears that these projections were overly optimistic. Substantial capital outflows forced the central bank to boost its discount rate to a record 10% in January. And in February, it was revealed that January consumer prices rose an alarming 3%—a figure that mocks the 7% official forecast for the year and threatens the delicate negotiations on a national wage agreement. Some private forecasters are now looking for 16% inflation in 1980, a rising balance-of-payments deficit, and growth of between 1.5%-2.25%.

Ecuador steps up oil exploration efforts.

Increased petroleum earnings have given Ecuador's foreign trade position a big boost. Although rising domestic consumption cut into export supplies, large oil price rises nearly doubled oil export revenues to $1 billion in 1979. As a result, the trade surplus widened to about $300 million from $217 million in 1978. With oil contributing about half of total export revenues, the Government is seeking to boost the country's 1.1 billion barrels of proven reserves. Exploration is being stepped up with the goal of achieving proven reserves of 2 billion barrels by 1984. The authorities are hoping that these efforts, which include incentives to attract international oil firms and deeper drilling and recovery techniques, should result in an average output of 230,000 barrels per day by 1982, as compared with 214,000 last year.

Higher oil prices and restrictive policies aid Venezuelan economy.

Restrictive demand-management policies, combined with much higher petroleum prices, improved Venezuela's economic situation substantially last year. Large cutbacks in central government expenditures lowered the budget deficit from 5.8% of GDP to about 1%, while monetary growth decelerated to 9.4% by fourth-quarter 1979 from 15.2% a year earlier. The resultant dampening of aggregate demand reduced pressure on imports. Import costs in 1979 registered no increase over 1978, which represents a decline from 28% of GDP to 24%. And since export earnings rose 50% as petroleum prices and volumes soared, the trade balance posted a $2.8-billion surplus. Thus, the current-account deficit is estimated to have shrunk from $5.3 billion in 1978 to about $1.5 billion last year. Official reserves, moreover, rose $1.3 billion to $7.7 billion by year-end. The conservative policies pursued, however, reduced growth from 4.8% in 1978 to some 3% in 1979, reflecting mostly gains in oil output. Inflation, on the other hand, continued to rise —reaching 20.5% by year-end—owing to the lifting of selected price controls, general wage increases, and interest rate adjustments.

Australia will see slower, but still satisfactory, growth in 1980.

Australian economic growth in the current fiscal year (ending June) is expected to slow somewhat from last fiscal year, but will still post a healthy increase. Although agricultural production will fail to match last year's 36% increase, continued strength in industrial production and investment—particularly in mining—are buoying the economy. Consumer spending, which accounts for 60% of GDP, is also exhibiting strength, spurred by delayed expenditures stemming from the sharp rise in farm incomes last year; it is estimated to rise about 2.5% in real terms, roughly the same as last fiscal year. Exports are performing extremely well, paced by increased demand for farm products and a surge in mineral exports. Exports rose 35% to nearly $10 billion in the first half of the fiscal year and are likely to sustain a strong, albeit slower, pace in the second half. The recent adoption of a tight monetary policy is expected to dampen growth during the second half, contributing to the slower real GDP growth rate of 3.5% anticipated for this fiscal year, as against 4.7% last year.

Jordan's economy on a strong growth uptrend.

Jordan's economy posted a 7% real growth rate in 1979, led by an 18% increase in industrial production and financed by nearly $1 billion in grants from other Arab governments. An even stronger performance is expected this year. Unusually plentiful winter rains have softened the impact of a fifth successive year of drought; a major new oil refinery is nearing completion; and phosphate production is set to expand rapidly again. Inflationary pressures in the domestic economy are building, however, fed by fuel price rises and the continued growth in domestic liquidity stemming from heavy remittances from workers abroad. No balance-of-payments problems are anticipated in 1980, despite a $100-million hike in the oil bill, because of the projected inflow of $1.6 billion in aid grants and remittances. And the level of foreign reserves remains exceptionally high, at more than $1.5 billion, sufficient to cover nearly 10 months of imports.

Rice prices to hold firm during 1980.

World rice production for the 1979/80 marketing season is estimated at 372 million metric tons, down 3½% from the record 1978/79 crop. The U.S. crop, which generally supplies about a quarter of total world exports, is expected to exceed last year's record output because of improved per-acre yields. But India, the free world's largest producer of rice, will experience a severe shortfall, owing to the worst drought in 40 years. And supplies available for export from Thailand will be down as a result of increased domestic consumption triggered by the influx of refugees from Cambodia. Currently excessive world stocks should be drawn down by more than three million tons over the course of 1980, much of this occurring in India. World rice prices, which have risen sharply in recent months, are therefore expected to remain firm throughout much of 1980.

New Pressures on Borrowing

The growth in both business loans at banks and nonfinancial commercial paper has accelerated significantly since mid-December. Moreover, there are no indications that this rapid growth in short-term business credit—which reversed the slowdown that had occurred after the Federal Reserve's October 6 policy move—will abate soon. Indeed, many analysts feel that the deteriorated conditions in the bond market, as well as the fear that credit availability may soon be curtailed, may be leading to an acceleration in short-term business borrowing.

From mid-October to mid-December, business loan growth at banks decelerated significantly, as did the growth in commercial paper. This slowdown, however, proved to be temporary. From mid-December to mid-February, business loans at large banks grew at an annual rate of almost 30%, while the volume of nonfinancial commercial paper outstanding increased at an annual rate of over 150%.

The combination of continued economic strength and accelerating inflation is one obvious reason for the resurgence in credit growth. Another source of both recent and near-term future strength in short-term credit demands, however, is the shifting of corporate borrowing from the bond market to banks and the commercial paper market. Corporate bond prices have exhibited unprecedented declines and volatility since January, and trading has been very thin. In such an environment, a number of corporations have had to postpone long-term bond offerings. Since corporations may be either unable or unwilling to alter significantly their near-term expenditure plans, however, they are likely to be looking to banks and commercial paper for their financing needs.

Recent indications that some kinds of more restrictive credit measures are being considered have heightened fears of curtailed credit availability. Under the Credit Control Act of 1969, the President may authorize the Federal Reserve to regulate any or all extensions of credit. Obviously, there are numerous forms that such regulation could take. Business firms as well as consumers could be covered. And as this issue goes to press, an announcement is distinctly possible.

A new credit program (probably coupled with other measures, although not broad controls on wages and prices) would not likely be designed to produce severe liquidity strains in the economy. Instead, it probably would be geared more toward influencing more cautious spending plans in coming months. As such, the near-term effects on inflation would be modest at best. And in fact, with underlying credit needs reasonably high in coming months, new credit measures pose a risk of aggravating current economic problems. A strong surge of new anticipatory borrowing would produce higher rates of interest and inflation and also prospects for serious financial dislocations.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE				
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	
Argentina	Prospects are for 3% real GDP growth in 1980, with some downtrend in inflation.	Nov.	0	102.0	$3,825	Oct.	9,175	+ 78%	27.2	
Barbados	Record tourist arrivals and new industrial investments spur economic growth.	Aug.	+ 43%	0.5	2,000	Dec.	67	+ 12%	2.1	
Bolivia	Economic austerity program being implemented in connection with IMF stand-by loan.	Sept.	+ 27%	4.7	930	Dec.	174	+ 2%	2.6	
Brazil	Monetary and fiscal policy restrictive in effort to stem inflationary pressure.	Nov.	+ 18%	209.1	1,760	Sept.	9,260	− 7%	5.8	
Chile	Fiscal policy tightened in effort to reduce 39% inflation rate.	Oct.	+ 75%	19.0	1,710	Dec.	1,938	+ 78%	4.8	
Colombia	Government investment in energy, transport, and communication should sustain 6.5% growth in '80.	Dec.	+ 19%	28.7	1,100	Dec.	3,844	+ 63%	13.9	
Ecuador	New five-year plan being drawn up projects 6.5% annual growth, stressing oil and agriculture.	June	+ 33%	8.7	1,070	Dec.	767	+ 15%	4.8	
El Salvador	Mounting political tensions posing serious obstacle to business; GDP growth fell to 3.5% in 1979.	June	+ 48%	3.4	760	Dec.	140	− 48%	1.6	
Guatemala	Authorities aim to curb 14% inflation via tighter price controls and higher agricultural output.	Dec.	+ 16%	7.2	1,060	Dec.	696	− 6%	5.9	
Honduras	Public spending on hydroelectricity, forestry, and infrastructure continues heavy.	June	− 3%	1.9	540	Dec.	209	+ 13%	3.8	
Mexico	Business activity brisk; strong increases in oil production, manufacturing, and construction.	Nov.	+ 53%	118.0	1,700	Sept.	1,887	+ 11%	2.0	
Nicaragua	Emergency reconstruction plan emphasizes agriculture; $40 million from abroad available for industry.	May	+210%	1.7	660	Nov.	88	+ 42%	2.0	
Panama	Economic activity approximating 4% real growth, paced by uptrend in construction.	Sept.	+ 15%	2.7	1,420	Nov.	111	+ 13%	4.4	
Paraguay	Economic growth reached 9.5% in 1979, but inflationary pressures intensified.	Sept.	− 2%	3.7	1,225	Dec.	609	+ 56%	14.6	
Peru	Government grants tax incentives and ups minimum salary 20% to boost domestic purchasing power.	Sept.	+107%	12.1	700	Dec.	1,520	+290%	12.9	
Puerto Rico	Slowdown in construction and some drop in employment reflect recent softening in economy.	Nov.	+ 17%	10.2	2,925	Nov.	3,500*	+ 18%	9.2	
Trinidad & Tobago	Increases in sugar and oil export earnings help sustain healthy business climate.	July	+ 21%	3.8	3,465	Dec.	2,138	+ 19%	14.2	
Venezuela	Demand-management policies of 1979 likely to ease in view of high oil prices and social tension.	Dec.	+ 90%	48.1	3,386	Dec.	7,284	+ 21%	7.4	

*Commercial bank deposits

A Spending Spree This Spring?

Retailers will not be the only ones anxiously anticipating consumer behavior this spring. Up to now, consumers have demonstrated a willingness and ability to maintain spending in the face of rising prices and declining real incomes. So in view of the alarming rise in January prices, economists and government policymakers will be nervously watching for signs that the spending spree has run its course, in hopes that this will contribute to an easing of inflationary pressures.

The report that consumer prices in January rose at an annual rate of 18% caused anxiety on the inflation front, particularly in light of the news that producer prices in the same month surged at a rate of 21%. Both figures represent sharp accelerations over 1979 rates. In addition, retail sales in January were surprisingly strong after a better-than-expected Christmas season, indicating that consumer spirits are still buoyant. Most forecasters now expect the long-predicted recession that was to have provided some relief from soaring prices to be pushed further into the future.

Although real incomes have declined almost 1% over the past six months, consumers have not reduced their spending pace. Such behavior is not irrational. The high spending levels have been induced largely by expectations that inflation is not likely to ease in the near future. Consumption has also been bolstered by cheap and easy borrowing and by increases in the wealth of many homeowners who have cashed in on inflationary spurts in home prices. At the same time, ceilings on passbook interest rates and the tax treatment of savings have made traditional forms of saving unattractive.

Consumers are probably correct in their expectations that high and volatile inflation rates will continue —at least in the near term. Mortgage interest rate hikes and price increases by foreign oil producers leave little room for optimism that prices for shelter and energy will moderate before mid-year. And the January CPI figures indicate that the acceleration of inflation is broader based. Prices for services and non-food commodities over the past three months have risen at an annual rate of 11%, compared with an 8½% rate of increase in the three months prior. But a continued worsening of inflation will depend largely on both consumers' ability and willingness to sustain their strong buying pace.

There are signs, however, that consumers' *ability* to maintain spending is tapering off. Consumer instalment credit growth has slowed; and high mortgage interest rates have dampened both housing demand and homeowners' ability to tap increased equities in their homes. In addition, continued declines in real personal income are expected.

Consumers' *willingness* to continue spending will be influenced by government policy. If consumers sense that the Government's resolve to "do something about inflation" will finally bring on recession, they are likely to curb their spending. But they will require some convincing signals.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
e of IMF dit, mil- of dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	February 27, 1980		current monetary conditions	
0	Slower devaluation-rate policy continues.	Jan.	+130%	Oct.	+188%	18.00%	.00064	Interest rates decline.	Argentina
9	Sugar export earnings rise strongly.	Nov.	+ 17%	Oct.	+ 16%	—	.5200	Credit growth moderate.	Barbados
0	Devaluation and stabilization measures should improve balance of payments.	Sept.	+ 12%	Sept.	+ 28%	—	.0520	Monetary policy restrictive.	Bolivia
0	Pre-fixed 40% devaluation announced for 1980.	Jan.	+ 82%	Aug.	+ 52%	33.00%	.0240	Cruzeiro availability very limited.	Brazil
9	Higher copper prices enhance trade performance.	Dec.	+ 39%	Aug.	+ 48%	—	.0275	International reserves continue to rise.	Chile
0	International reserves up a hefty $1.6 billion in 1979.	Oct.	+ 27%	Dec.	+ 15%	20.00%	.0275	Tight credit policy to offset rapid reserve growth.	Colombia
0	Trade surplus reached record level in 1979.	Oct.	+ 9%	Aug.	+ 33%	8.00%	.0400	Commercial loans up 24% as of end-year.	Ecuador
0	Exports hurt by agricultural output declines; foreign investment down.	Aug.	+ 7%	Nov.	+ 18%	—	.4025	Local capital is scarce.	El Salvador
0	High coffee prices and nickel export volume raised export receipts 16% in '79.	Oct.	+ 14%	Oct.	+ 28%	—	Par	Tight credit policy prevails.	Guatemala
0	Trade deficit in 1979 widened to about $240 million.	Sept.	+ 9%	Sept.	+ 22%	4.00%	.5010	Reserve requirement raised.	Honduras
6	Oil export rate reaches 1 million barrels per day.	Nov.	+ 19%	Oct.	+ 29%	4.50%	.0440	Long-term peso interest rates increased.	Mexico
7	Export earnings expected to fall slightly, owing to some missed plantings.	Dec.	+ 30%	Aug.	+ 56%	—	n.a.	Funds in short supply.	Nicaragua
2	Canal service receipts show strong increase.	Sept.	+ 9%	Sept.	+ 11%		Par	Credit growth rises moderately.	Panama
0	Large increase in soybean-product exports.	Dec.	+ 35%	June	+ 20%	—	.0080	Domestic loan volume up sharply.	Paraguay
2	Tariffs cut further to reduce inflation and spur domestic output efficiency.	Aug.	+ 65%	Aug.	+ 33%	29.50%	.0043	Net foreign assets continue to rise.	Peru
C	Tourism activity brisk.	Dec.	+ 10%	Nov.	+ 9%	—	Par	Interest rates rising.	Puerto Rico
0	Large increase in exports to Europe.	Nov.	+ 18%	Sept.	+ 29%	6.00%	.4300	Loans to manufacturing sector up substantially.	Trinidad & Tobago
0	Oil export earnings up 52% in 1979.	Dec.	+ 20%	Oct.	+ 13%	8.50%	.2335	Foreign reserves rising rapidly.	Venezuela

World Interest Rates

market rates of February 27, 1980; bond yields as of February 22, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00	14.00	17.00	12.00	9.50	7.00*	15.00 penalty rate 18.00	9.50	3.00	7.25
Day-to-Day Money	14.75 Feb. 28	12.50	17.25	8.75	12.375	8.20	16.625	10.50	1.00**	9.5625
Treasury Bills 91-day, Middle Rates	13.80	13.50	16.0625	14.75 120-day	n. a.	n. a.	14.875 90-days	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	13.50 finance paper	13.85 finance paper 15% tax w/h	15.43	10.40 Certified	13.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	15.00	13.85 15% tax w/h	17.375	12.50 Certified	not traded	8.40	18.15	no market	4.00** not traded	no market
Government Bonds Long-term, new and old issues, average yield	12.55	13.40	14.31	10.87 20% tax w/h	13.10	8.66	14.12	10.53	4.49**	8.34**
Industrial Bonds prime, long-term, new and old issues, average yield	13.35 Aa Industrials	13.95	14.50	13.08 20% tax w/h	13.66	8.48	14.49	11.68	5.39**	6.95**
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	15.00	18.00	15.50	13.60	9.75	20.00	13.50	4.50**	7.50
Bank Time Deposits 3-month	14.75 Cert. of Dep.	13.85 Cert. of Dep.	17.75	14.95	13.25	8.95	10.75	12.50 large deposits	5.375** residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	16.375	no market	18.125	no market	15.00	9.75	no market	13.00	6.125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8714	2.2840	.03496	.2424	.5681	.001225	.5154	.5999	.004028
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.25 *P*	1.75 *D*	1.50 *P*	2.125 *P*	6.75 *P*	3.00 *D*	3.75 *P*	11.00 *P*	6.25 *P*

Eurodollar Deposits
(London, interbank, bid)
February 28

7-day	14.5625
1-month	15.625
3-month	16.6875
6-month	15.8125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .29
U.S.-Canada Treasury Bills	−2.33
U.S.-Canada Finance Co. Paper	−3.41
Eurodollars-U.K. Local Auth. Deposits	+ .88

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.25
Over 7 yrs.	15.50
DM Bonds	
7 yrs. and under	9.50
Over 7 yrs.	9.75

Gold Price
London afternoon fixing
636.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Effective Feb. 29. ** Market rates as of Feb. 20; bond yields as of Feb. 15.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	13.9 (Jan.)	9.5 (Jan.)	18.4 (Jan.)	12.9 (Jan.)	5.0 (Jan.)	19.8 (Dec.)	5.1 (Jan.)	6.2 (Jan.)
Industrial production*	0.8 (Jan.)	2.3 (Nov.)	2.5 (Dec.)	3.8 (Dec.)	6.7 (Dec.)	8.2 (Dec.)	0.9 (Oct.)	8.4 (Dec.)
Trade balance† *(billions of local currency units)*	−4.76 (Jan.)	C$.727 (Dec.)	−£.35 (Jan.)	−FF4.63 (Jan.)	DM.80 (Dec.)	−Lit1,720 (Dec.)	−SF.92 (Jan.)	−¥281 (Jan.)
Money supply (M_1)*	8.0 (Jan.)	7.6 (Jan.)	10.9 (Nov.)	10.9 (Nov.)	9.3 (Nov.)	24.6 (Oct.)	−2.4 (Nov.)	7.9 (Dec.)
Velocity of money (M_1)*	5.9 (Sept.)	5.2 (Sept.)	4.8 (Sept.)	11.5 (Sept.)	0.1 (Sept.)	−3.1 (June)	n.a.	−2.2 (Sept.)
Reserves minus gold *($ million, change from previous month)*	−232 (Dec.)	−85 (Dec.)	+499 (Dec.)	+960 (Dec.)	+3,285 (Dec.)	−116 (Dec.)	+2,500 (Dec.)	+164 (Dec.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Singapore's New Development Strategy

The small island state of Singapore is today the second richest nation in Asia, with a per capita GNP of $3,700. The country, whose inhabitants are 75% Chinese, possesses a solid economic base in manufacturing and services, a tribute to its sound economic management and disciplined labor force.

The economy reached its "takeoff" stage soon after Singapore attained its independence in 1965. The country's economic base was broadened through policies aimed at building up export-oriented industries with emphasis on labor intensity. Singapore financed the subsequent development with heavy reliance on foreign capital and technology, necessitated by its smallness and limited domestic saving capacity. Between 1968 and 1978, real GDP grew an average 10% per annum. Real growth last year was 8.5%, and the Government is planning on an average annual growth rate of 8% through the 1980s.

While Singapore is determined to sustain its rapid growth pace, the nature and course of its growth will be altered in the coming years. The authorities are concerned about the fast growth in the labor force—particularly the foreign component—over the past few years. Of the 7% average annual growth achieved between 1974 and 1978, productivity growth accounted for only 3%, while labor force growth made up 4%—2.5% of which came from abroad.

Singapore's labor-intensive development course was motivated by the Government's desire to redress serious unemployment problems in the economy. And the results were impressive; Singapore's rate of unemployment declined steadily from 7.3% in 1968 to 3.5% last year, at the same time that the labor force grew about 4%-4.5% per annum. Indeed, the country has now achieved full employment, and since Singapore does not wish to support a large population, it is seeking to raise productivity by shifting from labor-intensive to more capital- and technology-intensive industrial development. Accordingly, the Government unveiled a development strategy last year aimed at arresting the increasing utilization of migrant labor and transforming the country's labor-intensive industrial structure. The three-pronged strategy consists of:

1. a high-wage policy—which has boosted the national wage bill by 20%—to encourage employers to upgrade their operations and reduce their demand for unskilled labor;
2. expansion of technical and engineering manpower to meet the expected needs of high-technology, skill-intensive industries; and
3. incentives to attract foreign investment embodying capital and technology.

While the strategy is basically sound, it carries with it certain risks or potential problems. First, the high-wage policy runs the risk of boosting unemployment and the rate of inflation—which climbed to about 8% in 1979. This risk is minimized, however, by the relatively small impact of the higher wages on manufacturers' total costs, and the moderate, and possibly only short-run, impact on the country's inflation rate. The Government has nonetheless taken steps to smooth the adjustment process; these include accelerated depreciation allowances, and government assistance to firms for retraining workers and upgrading technology. A key concern is whether there will be a continuous flow of highly skilled workers to sustain the high-wage policy over the long run.

A second risk is that the manpower training programs will fail to emphasize the appropriate skills. Specifically, Singapore's quality education system has historically stressed industrial training. But the country's manufacturing sector is not expected to expand much beyond its present relative size, while the service sector is likely to grow in importance. Thus, manpower training programs must be reoriented and broadened—and respond to changes in labor needs over time.

The third risk or potential problem concerns the availability of capital. The new plan is counting on productivity growth to contribute at least 6% to the targeted 8% average annual growth in the 1980s. This will necessitate much higher capital/labor ratios in production, which in turn means that Singapore will have to generate substantially higher saving levels, both foreign and domestic. And although Singapore has attracted considerable foreign capital—mostly in the form of foreign direct investment rather than loans—it will face stiff competition from other Asian countries, such as Hong Kong and Taiwan, for a limited pool of foreign investment funds in the 1980s. Thus, increased domestic saving will be needed, particularly for use in the private sector where foreign capital has traditionally predominated. But the domestic financial sector is still relatively unsophisticated, and Singapore will have to introduce new mechanisms for raising and sustaining the necessary domestic savings. Even so, Singapore may have to depart from its tradition of minimal reliance on external debt.

One final risk is that the authorities will make inappropriate choices of technology or industry. While Singapore's managers have proven to be skilled decision-makers, their choices in this instance are especially difficult, and must be based on long-term considerations, both internal and external. Internally, the choices must be cognizant of the structural evolution of the economy, while externally, they must minimize the economy's competitiveness with its neighbors and maximize its complementarity.

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Holland Follows the Rest of Europe

The economy of the Netherlands is small and open, with its most important structural characteristics its trade dependence and large reserves of natural gas. Despite these features, which subject the Dutch economy to the vicissitudes of its external sector and the international economy, the country's growth has been stable, ranging between 2%-3% annually between 1977 and 1979, with an inflation rate for the same period averaging 5.1%, among the lowest in Europe.

Exports and imports each account for about half of Holland's $131-billion GNP. This high degree of trade dependence implies that the authorities have only a limited degree of control over aggregate demand. Furthermore, the "tradable" component of Dutch output (exportables and importables) is even larger than the portion actually traded. This degree of openness means that the Dutch price level is largely determined on world markets through international goods arbitrage. The price level in guilder terms can therefore be changed significantly only if the exchange rate changes. But this option is circumscribed by Holland's membership in the European Monetary System (EMS). Membership in the EMS also restricts the authorities' freedom to target a rate of monetary expansion.

The Netherlands' reserves of natural gas are a big influence on the country's external accounts. Proven reserves are estimated at about 2,227 billion cubic meters, and production and export figures since 1974 are as follows:

	1974	1975	1976	1977	1978	1979*	1980**
Production *(billion cubic mtrs.)*	83.7	90.9	97.3	94.8	90.2	100.0	n. a.
Exports *(billion cubic mtrs.)*	40.1	41.6	43.4	50.0	45.0	50.5	50.5

*estimate **forecast

Both gas production and export volume are expected to decline between 1980 and 1990, to some 66 and 28 billion cubic meters, respectively. This assumes, however, that no new discoveries are made and that potential reserves are discounted; if these assumptions prove incorrect, production and export levels could rise sharply over the next decade.

The Dutch economy performed unspectacularly in 1979. Real growth was an estimated 2%, and despite a sharp increase in natural gas output, industrial production registered no growth. The inflation rate was held to some 4.7%, despite a sharp rise in the price of of raw materials.

The volume trade balance was strong during the first three quarters of 1979—export volume was up 8.7% as against an import volume increase of only 6.5%. But an unfavorable shift in the terms of trade widened the trade deficit. The Dutch Central Planning Bureau estimates the 1979 current-account deficit at 1.5 billion guilders, compared with a 2-billion guilder gap in 1978.

The 1979 deficit stems in large part from Holland's energy balance. The country is a net exporter of natural gas and a net importer of petroleum products. Movements in the natural gas price tend to follow those of the oil price, but with a lag of six to nine months. Thus, in 1979, the average price of oil rose by over 50% while the average price of gas rose only 6%. This resulted in an estimated 1979 energy deficit of 2.5 billion guilders; thus, Holland had a non-energy current-account *surplus* of about 1 billion guilders.

The current year promises not much improvement in the Dutch economic performance. On the external front, the growth in the volume of world trade, weighted by Dutch export shares, is expected to decline sharply from 7% in 1979 to 2% this year. High inflation is expected to persist in the economies of Holland's trading partners, and the average per-barrel cost of oil will rise to $32, 62% higher than the 1979 average. The Central Planning Bureau is forecasting a current-account deficit of some 2.5 billion guilders, and some private forecasters are suggesting an even larger shortfall.

On the domestic front, the Government has not succeeded in reducing the public-sector deficit to 4%-4.5% of national income as it had proposed to do. With the sluggishness of the domestic economy, the public-sector deficit is now expected to be 5.5% of national income in 1980, roughly unchanged from last year's 5.7%. Wages are expected to rise by some 1.5%-2% in real terms when the current wage freeze expires, and higher costs already in place at the wholesale level point to retail price inflation of 6%-7%. Despite this, corporate profit margins are expected to be squeezed. On balance, real growth in 1980 is forecast to decline to about 1%, with the weakest points, capital investment and export volume.

Over the longer run, Holland is faced with several problems. Increasing the price-competitiveness of Dutch exports with a devaluation is difficult because of wage indexation, which would prevent any *real* reduction in the guilder's exchange value. Thus, in order to make exports more competitive, unit labor costs must rise less quickly in Holland than in its major trading partners.

Holland also faces the prospect of ultimately becoming an increasing net importer of energy. Thus, it will eventually have to reduce domestic absorption relative to output, which would mean that living standards would grow less quickly than output. This problem, however, is shared with several other European countries, and Holland's reserves of natural gas give it the opportunity for a slower rate of adjustment.

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